Minutes Of The Meeting Of The
Treasury Borrowing Advisory Committee
Of The Bond Market Association
October 30-31, 2006

The Committee convened in closed session at the Hay-Adams Hotel at 3:35 p.m. All Committee members were present except Gary Cohn and Thomas Juterbock. Under Secretary Robert Steel, Deputy Assistant Secretary James Clouse, and Office of Debt Management Director Jeff Huther welcomed the Committee and gave them the charge.

As background to the discussion of the questions in the charge, Director Huther began by briefly presenting the November Quarterly Refunding charts found at http://www.treas.gov/offices/domestic-finance/debt-management/qrc/2006/2006-q4-chart.pdf. Treasury did not present additional charts to the Committee.

Director Huther highlighted several of the charts related to financing needs for previous quarters as well as the coming years. Strong receipts, coupled with moderate growth in expenditures, have resulted in lower borrowing needs. If this trend, now in its third year, continues, reductions in issuance will be needed. While Treasury's initial response would most likely be reductions in issuance sizes spread across all real and nominal maturities, the impact would first show up as a reduction in the shares of the portfolio devoted to short term securities. Treasury will need to be attentive to concerns of maintaining sufficiently liquid issuance sizes if the federal deficit improves as, or significantly better than, consensus forecasts. Huther noted that given these forecasts growth in Treasury supply could be limited.

Huther also addressed several other charts including one related to the average maturity of issuance which showed an increase as a result of slightly higher 30-year bond issuance in the coming years to accommodate quarterly issuance. With annual issuance of the 30-year bond shown at the upper end of the $20 billion to $30 billion range that was given as guidance in 2005, the average maturity of issuance in 2007 would be six months higher than in 2006.

The Committee then addressed the first question in the charge (attached) regarding the fiscal outlook over the near to intermediate term given that the federal budget deficit is projected to decline sharply after rising in fiscal year 2007. Director Huther referenced the previously viewed charts before opening the discussion to the Committee.

In their discussion, members generally agreed that receipts would remain fairly strong and that the economy's performance to date has been robust. Members noted that the economy has been resilient despite numerous impediments including higher energy prices and a slowing housing market. Members generally noted that it may be premature for Treasury to consider significant reductions in the auction calendar.

One member pointed out that recent average forecast errors anticipating even better deficit projections may not come to fruition even if such was the case in the past. Another member noted that the political environment in Washington in the coming years may not be favorable, and as a result, federal spending may remain at current high levels while receipts begin to trail off as a result of a slowing economy. Therefore, Treasury may want to proceed cautiously in deciding on reducing issuance.

Director Huther asked the Committee if reduced borrowing needs could be accomplished through the bill market, and if such volatility in bill issuance would be detrimental. Committee members generally agreed that the bill market was flexible enough to handle large shifts in issuance, and that additional volatility in that market was not a major factor with which to be concerned. Some members noted that at this point in time, a combination of reducing coupon sizes while actively managing bill issuance would be a better strategy than eliminating a specific security or readjusting the calendar.

One member noted that outlays remain at fairly high levels while receipts may be at an inflection point given the recent gross domestic product data. Another member added that the bill market could handle the volatility resulting from any unexpected improvement in the deficit and that waiting until the new calendar year may be sensible before making dramatic cuts.

A committee member noted that Treasury had plenty of capacity to raise debt given the current calendar, and that the market could tolerate slightly lower coupon sizes. Another member suggested that Treasury consider eliminating the 3-year note if needed, but until greater clarity on receipts is obtained in 2007, reduced bill issuance and lower coupon sizes spread across maturities would be the optimal strategy.

The Committee then addressed the second question in the charge regarding the impact of a slowing housing market on the outlook for the U.S. economy and financial markets. Specifically, the Committee was asked if such a slowdown could have repercussions for the Treasury market.

The Committee began to discuss the weakness in the housing market and the resilience the economy has shown in spite of the decline in activity. Some members felt that housing prices were returning to trend, but lower energy prices and higher equity market prices were moderating the impact on the overall economy.

One member noted the pace of price declines was something to closely watch, and that the Treasury market could be impacted if a severe decline in prices led to a deflationary environment. Another member noted other factors were countering the decline in housing prices, and that lower rates were resulting in significant refinancing of adjustable rate mortgages which may result in lower overall risk to the economy.

Another member added that adjustable rate mortgage resets were less of a risk factor given that significant portion of such loans are held by higher income individuals.

A member noted that the existing high levels of outstanding supply in the housing market needed to be monitored, but overall sales volume indicators remain healthy. Several members noted that the role of the Fed in potentially lowering rates as a result of a severe housing fall needed to be considered. The member also stated that concerns over a severe housing decline have occurred several times over the past decade with no follow through. Another member added that price declines following a bubble could impact other financial markets, but given that the fall in prices has been relatively gradual, its impact could be muted.

Members noted the strength of the economy would play a critical role in determining the eventual impact on the economy and the Treasury market, but given lower energy prices and higher equity prices, such effects may be lower than anticipated.

Next, the Committee was asked about the mixed signals emanating from the financial markets. In particular, members were asked to reconcile the recent move higher in equity markets and the narrowing of credit spreads with the flat to inverted Treasury yield curve that some suggest indicate an economic slowdown. The Committee was also asked if a sudden increase in volatilities or risk premiums posed significant risks to the liquidity of financial markets.

The Committee generally felt that the enormous liquidity of global financial markets as well as a sense of complacency amongst market participants may be the cause of the contradicting signals. Moreover, several members noted that deriving a signal from the shape of the yield curve may be tenuous given the large foreign flows the Treasury market is experiencing.

Several members agreed that the value of the yield curve as a signal had diminished over the years, and that other factors needed to be considered. One member noted that while some equity markets have risen, equities as a whole on a price-earnings basis remained relatively attractive. Credit market spreads, however, remained surprisingly tight. The low rate of defaults, the strength in corporate balance sheets, and diversification by foreign investors may be causing the narrowing of spreads in credit markets.

One member suggested that the narrowing of credit spreads was not an indicator of strength in the economy but of complacency amongst investors seeking yield.

Another member noted that the overall liquidity of the Treasury market was driving foreign flows, and that such liquidity would remain persistent given the global nature of the market. Several members reiterated the importance of the liquidity provided by the Treasury market to international capital flows, and noted that while diversification may take place, only the Treasury market could handle such enormous flows. As a result, a sudden upward shift in volatility may have minimum impact on the Treasury market.

The Committee generally felt that the low level of volatility in financial markets was also being driven by the liquidity across global markets, and that recent tightening of short-term rates was not enough to drain such liquidity. One member stated that lower foreign demand or a sudden rise in inflation or deflation expectations could lead to a rise in volatility, but that the impact of such a rise would be muted as marginal buyers seeking yield emerge.

One member noted that volatility may be muted as some large investors choose not to hedge optionality related to mortgage securities. Another member believed that gross leverage had risen significantly over the past few years, and that a sharp rise in volatility could impact financial markets. However, if global liquidity remains at such high levels, or if rates begin to decline to offset a slowing economy, the impact could be short-lived.

Finally, the Committee discussed its borrowing recommendations for the November refunding and the remaining financing for this quarter as well as the January – March quarter. Charts containing the Committee’s recommendations are attached.

The meeting adjourned at 4:30 p.m. on October 30.

The Committee reconvened at the Hay-Adams Hotel at 11:45 a.m. on October 31. All the Committee members were present except Richard A. Axilrod, Michael Haddad, Mohamed El-Erian, and Susan Estes. The Chairman presented the Committee report to Under Secretary Steel. A brief discussion followed the Chairman's presentation but did not raise significant questions regarding the report's content.

The meeting adjourned at 12:00 p.m.

Jeff Huther
Director
Office of Debt Management
October 31, 2006

Certified by:

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Thomas G. Maheras, Chairman
Treasury Borrowing Advisory Committee
Of The Bond Market Association
October 31, 2006

Treasury Borrowing Advisory Committee Quarterly Meeting
Committee Charge – October 30-31, 2006

Fiscal Outlook

Looking ahead, the Federal budget deficit is projected to increase in FY07 and then decline sharply. What is the Committee's view on the fiscal outlook over the near-to-intermediate term? Is Treasury well positioned to address its future funding needs?

Housing Market and the Treasury Market

We seek the Committee's views on the impact of the slowdown in the housing market on the outlook for the U.S. economy and financial markets. Are there potential repercussions for the Treasury market?

Mixed Financial-Market Signals

Recently, equity markets have hit new highs while credit spreads, implied volatilities, and measures of interest rate risk premiums have remained low. These financial market indicators would suggest a favorable economic outlook; yet the Treasury curve remains flat or inverted and priced below the FOMC's target for the Federal Funds rate, which some have interpreted as foreshadowing economic weakness. What is the Committee's view on these seemingly contradictory financial market signals? Would a sudden increase in volatilities or risk premiums pose significant risks to the liquidity of financial markets?

Financing this Quarter

We would like the Committee's advice on the following:

- The composition of Treasury notes to refund approximately $57.6 billion of privately held notes and bonds maturing or called on November 15, 2006.
- The composition of Treasury marketable financing for the remainder of the October-December quarter, including cash management bills.
- The composition of Treasury marketable financing for the January-March quarter.